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DEMUTUALIZATION AND CORPORATIZATION OF STOCK EXCHANGE IN INDIA

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ABSTRACT

The origin of the stock market in India dates back to the end of the 18th Century after the enactment of the companies Act in 1850 which introduced the feature of limited liability. The Native Share and Stock Brokers' Association, now known as Bombay Stock Exchange (BSE) was formed in Bombay 1875. This was followed by the formation of association /exchange in Ahmadabad (1894), Calcutta (1908) and Madras (1937). In order to promote the orderly development of the stock market the central government introduced a comprehensive legislation called the Securities Contracts (Regulation) Act, 1956. According to section 2(3) of this Act the stock exchange has been defined as "anybody of individuals whether incorporated or not, constituted for the purpose of assisting, regulating and controlling the business of buying, selling or dealing in securities". This paper also discusses the policy and present scenario of Demutualization of stock market in India.

KEYWORDS: Demutualization, Stocks Exchange, Brokers, Global, Securities. Regulations.

In India stock exchanges are free to establish themselves in any form of organisation, viz., a voluntary association of individuals, public limited company, company limited by guarantee, non-profit organisation etc. three stock exchanges, namely Bombay Stock Exchange, Ahmedabad Stock Exchange and Indore Stock Exchange have been organised as voluntary non profit making associations. This form is very suitable to the members as they can frame rules and regulations that suit them most. Membership can be acquired by inheritance or by purchase of a card of another member. The new card of membership can also be purchased from the stock exchange directly with the approval of other members.

Some exchange like those in Calcutta, Delhi, Madras, Bangalore etc. are organised as public limited companies. In this form, membership is acquired by purchasing the requisite qualifying shares. However, these shares are not freely transferable as in the case of a public limited company. The power of the members are derived from the memorandum of Association and Articles of Association of the company. The liability of the member is limited. However, the shares can be forfeited if the Governing Board of the stock exchange cancels the membership of any person. The stock exchange being a service unit normally does not declare dividend for the share holders.

Some stock exchanges are in the form of companies limited by guarantee. In this form there is no share capital. The liability of the members is limited to the extent of the guaranteed amount mentioned in the memorandum of Association and Articles of Association of the company. The membership can be acquired if the Board of Directors permits the same by passing a resolution in this respect. Normally each member has one vote in this form of organisation.

In all these organisation forms stock exchanges are regarded as mutual associations of members. The members who provide broking services own, control and manage the exchanges. Moreover the exchanges are regarded as not-for-profit organisation. Until 1988, the stock exchanges were more or less self-regulatory organisations supervised by the Ministry of Finance under SCRA. However, the stock exchanges had not been discharging their self- regulatory role well as a result of which malpractices had crept into trading adversely affecting the interests of the investors. In other words, the brokers who trade collectively own and run these exchanges. The ownership and managerial rights of the brokers often led to a conflict of interests where in the interest of brokers was preserved over that of the investors. Instances of price rigging, recurring payment crisis on stock exchanges and misuse of official position by office bearers have been unearthed in the last few years.

Several committees examined and made recommendations to reform the organisations of the stock exchanges. G.S. Patel Committee (1985), L.C. Gupta Committee (1991), Pherwani Committee (1991), G.S. Patel Committee (1995), Verma Committee (1997) are some of these committees. The Securities and Exchange Board of India (SEBI) has been set up in 1988 to ensure that stock exchanges discharge their self-regulatory role properly. To prevent malpractices in trading and to protect the rights of investors, the SEBI has assumed the monitoring function, requiring brokers to be registered and stock exchanges to report on their activities.

The Government has approved the scheme of demutualization and corporatization of stock exchanges in India in recent years after the study group constituted under the chairmanship of justice M.H. Kania has strongly recommended the same. It should be noted that demutualisation is the process by which any "member-owned organisation" can become a "share –share-holder owned" company. Through demutualization o stock exchange becomes a corporate entity, changing from a non-profit-making company to a profit mking and tax-paying company.

Demutualization separates the ownership and control of stock exchanges from the trading rights of its members. This reduces the conflict of interest between the exchange and the brokers and the chances of brokers using the stock exchanges for personal gains. With demutualization stock exchanges will have access to more funds for investment in technology, mergers with and acquisition of other exchanges, and for strategic alliances with other exchanges. Members of the stock exchange also benefit by demutualization as their assets become liquid and they get a share of the profits made by the exchange through dividends. Demutualization makes operations of the stock exchange transparent which facilitates better governance. The benefit of professional management is another advantage claimed by the demutualized and corporatized stock exchanges compared to the member-owned organizations. Demutualized and corporatized stock exchanges allow for greater flexibility in management. This is because, a publicity held company is better equipped to respond to changes as compared to a closely held and a mutually owned organization. In addition, a company can spin-off its subsidiaries, get into mergers and acquisition, raise funds etc.

To introduce demutualization and corporatization in India stock exchanges Kania study group was appointed by SEBI. The main recommendations of the Kania Group can now be mentioned.

(i) The stock exchanges which are set up as association of persons and those which are set up as companies limited by guarantee be converted into companies limited by shares. A common model for corporatization and demutualization be adopted for all stock exchanges. The SCRA 1956 need to be amended to provide that a stock exchange should be a company incorporated under the Companies Act.

(ii) As corporatization and demutualization of a stock exchange is essentially a conversion from a not-for-profit entity to a for-profit company., and would result in a distribution of assets, the Income Tax Act should be amended, if necessary , so that the past profits of a stock exchange should not be taxed when its character changes. In other words, accumulated reserves of the stock exchanges as on the day of corporatization should not be taxed. However, there would be no objection to taxation of these reserves in the hands of shareholders when these are distributed to them as dividend at the net applicable tax rate. All future profits of the stock exchange after it becomes a for-profit company may be taxed.

(iii) A statutory provision should be made in the Income Tax Act, so that the issue of shares trading rights in lieu of cards should not be regarded as transfer within the meaning of Section 47(xiii) of the Income Tax Act. The bye-laws, rules and articles of a stock exchange should be amended to provide for the allotment of shares and trading rights to its members upon corporatization and demutualization.

(iv) Necessary provision should also be made in the Indian Stamp Act and the Sales Tax Laws to exempt from stamp duty and sales tax, the transfer of assets from the mutual stock exchange and the issuance of shares by the new demutualization for-profit company, formed of demutualization.

(v) The Trading Card system should be replaced by the deposit system where in the money deposited by the member to obtain trading rights only, be considered as deposit with the stock exchange for trading purpose.

(vi) The three stakeholders, namely shareholders, brokers and investing public should be equally represented on the governing boards of demutualized exchanges. There should be specific vacancies on the board for each group of stakeholders . the share holders' representatives should not be elected by the shareholders from among the brokers of the exchange. The representatives of the investing public would be nominated by the SEBI from among a panel comprising of academics, professionals, public figures etc, none of whom should have any interest in any broking firm.

(vii) the roles and, hence, the posts of chairman and the chief executive officer (CEO) should be segregated. The chairman should be a person who has considerable knowledge and experience of the functioning of the stock exchange and the capital market. The chairman should not be a practicing broker. The stock exchange must appoint a CEO who would be solely responsible for the day to day functioning which would also include compliance with various regulations.

(viii) There should be a time limit with the approval of SEBI within which at least 51 percent of the shares would be held by non-trading members of the stock exchange.

(ix) It would be desirable for the demutualized exchange to list its shares on itself or any other exchange.

(x) There should be a ceiling of 5percent of the voting rights which can be exercised by a single entity or groups of related entities, irrespective of the size of ownership of the shares.

(xi) on the relevance of regional stock exchange, the Group felt that the concept of regional stock exchanges needs to be abolished. Some of stock exchanges could explore the possibility of merger on the lines of Euronext. However, the Group does not recommend any specific route as being mandatory as the choice should be dictated on commercial considerations.

The recommendations of the study Group have been approved by the SEBI subject to the following:

(a) While the existing members would be entitled to shares in the demutualized stock exchange in lien of their existing rights, the voting rights of the shares held by the broker shareholders would be determined by the SEBI in consultation with the Government of India.

(b) The Board of demutualized stock exchange would have equal representation of brokers, shareholders and the investing public. Thus, the broker-shareholders can have up to one-third representation on its Board.

(c) The names of all directors including the broker-directors to be appointed on the Board of the demutualized stock exchanges would require the approval of the SEBI.

Globally many stock exchanges have turned to corporate entities after being in a state of mutual companies. For example the Australian Stock Exchange was a mutual company when it was formed. Later in the year 1998 it became a corporatized stock exchange. In Singapore Exchange was established in 1999 as a corporate body through the merger of two mutual companies – the stock exchange of Singapore and the Singapore International Monetary Exchange. The London Stock Exchange too was set up as an association of stock-holders but subsequently it became a limited company in 1986. In India, the National Stock Exchange (NSE) is a demutualized stock exchange. Here the ownership and management of the exchange are completely divorce from the right to trade on it. It compares well with internationally available corporatized stock exchanges. NSE has a company form of organisation structure. It has a profit motive and profits are taxed. NSE is, however, not a listed company and no IPO has been made so far. It has a limited share holdership as there is no listing. NSE was set up as demutualized entity and hence there was no transfer of assets through a legislation.

It should be noted that a uniform model for corporatization and demutualization would have to be adopted by all stock exchanges. This model should not be made applicable selectively only for a few stock exchanges. Moreover, through the study Group feels that the concept of regional stock exchanges should be abolished, the view is not completely acceptable. The international experience in this respect is a mixed one. In some countries regional stock exchanges have merged into one single exchange. In many other countries small and regional stock exchanges continue to exist and their business has increased in absolute terms, while it has declined in relative terms. The situation in India appears to be quite similar. Given the country's size, and the need to service the fast growing investor population which is spread over a vast geographical area, and given the need to cater to many relatively small and medium sized firms located all over the country, the small regional stock exchanges can and should survive and grow. Apart from corporatization and demutualization what is needed is to create an integrated network of regional stock exchanges and to set up a central trading system for the regional stock exchanges.

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